Office of the Legislative Auditor

State of Montana

Report to the Legislature

April 1992

Financial-Compliance Audit

For the Fiscal Year Ended June 30, 1991

State Compensation Mutual Insurance Fund

This report contains four audit recommendations. Major issues addressed in the report include:

- Allocation of administrative costs.
- Improper benefit payments.
- Rate-making procedures.
- Solvency disclosure.

Direct comments/inquiries to:
Office of the Legislative Auditor
Room 135, State Capitol
Helena, Montana 59620

91-8A

FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Office of the Legislative Auditor to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations which could have a significant financial impact. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act of 1984 and OMB Circular A-128 require the auditor to issue certain financial, internal control, and compliance reports regarding the state's federal financial assistance programs, including all findings of noncompliance and questioned costs. This individual agency audit report is not intended to comply with the Single Audit Act of 1984 or OMB Circular A-128 and is therefore not intended for distribution to federal grantor agencies. The Office of the Legislative Auditor issues a statewide biennial Single Audit Report which complies with the reporting requirements listed above. The Single Audit Report for the two fiscal years ended June 30, 1989 has been issued. Copies of the Single Audit Report can be obtained by contacting:

Office of the Legislative Auditor
Room 135, State Capitol
Helena, MT 59620

STATE OF MONTANA

Office of the Legislative Auditor

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JAMES GILLETT
Financial-Compliance Audit

JIM PELLEGRINI
Performance Audit

April 1992

To the Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the State Compensation Mutual Insurance Fund, Department of Administration, for fiscal year 1990-91. We performed this annual audit of the state fund in compliance with section 39-71-2361, MCA. The report contains recommendations concerning compliance with state laws and policies related to state fund operations.

The written responses to audit recommendations are included at the end of the audit report. We thank the state fund president and his staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

Scott A. Seacat
Legislative Auditor

Office of the Legislative Auditor

Financial-Compliance Audit
For the Fiscal Year Ended June 30, 1991

State Compensation Mutual Insurance Fund

Members of the audit staff involved in this audit were: Mark C. Barry, Jeane Carstensen, John Fine, and Lorry Parriman.

Table of Contents

Appointed and Administrative Officials

State Compensation Mutual Insurance Fund Board of Directors and Executive Officers

Board Members		Term
James T. Harrison, Chairman	Helena	April 1993
Les Hirsch	Miles City	April 1995
Robert Holman	Kalispell	April 1995
Robert S. Short	Great Falls	April 1993
Clyde B. Smith	Kalispell	April 1993

Patrick Sweeney, President

James Murphy, Executive Vice President

John King, Vice President, Underwriting Department

Don MacMillan, Vice President, Benefits Department

Carla Smith, Vice President, Administrative and Finance Department

Nancy Butler, General Counsel

This listing below serves as a means of summarizing the recommendations contained in the report, the state fund's response thereto, and a reference to the supporting comments.

Introduction

The State Compensation Mutual Insurance Fund (state fund) was established by the 1989 Legislature to administer the state operated workers' compensation plan. Under state law, the Governor appoints five directors to set policy for the state fund. These directors hire a president to manage state fund operations. The state fund is attached to the Department of Administration for administrative purposes only. At June 30, 1991, the state fund had 218 authorized FTE. We performed a financial-compliance audit of the state fund for the fiscal year ended June 30, 1991 in accordance with section 39-71-2361, MCA. The objectives of the audit were to:

1. Determine state fund compliance with applicable laws and regulations.

2. Make recommendations for improvements in the management and internal accounting controls of the state fund.

3. Determine if the financial statements present fairly the financial position, results of operations, and cash flows of the state fund for the fiscal year ended June 30, 1991.

4. Determine the implementation status of prior audit recommendations.

This report contains four recommendations to state fund management. These recommendations address areas where compliance with laws and regulations can be improved. Other areas of concern deemed not to have a significant effect on the successful operations of the state fund are not specifically included in the report, but have been discussed with management.

In accordance with section 5-13-307, MCA, we analyzed and disclosed, if significant, the costs of implementing the recommendations made in this report.

Actuarial Soundness

During the May 1990 special session, the legislature enacted legislation providing separate funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund). Premium rates are to be set to cover actuarially estimated costs incurred on or after July 1, 1990. Premium revenue will no longer be used to cover the liability and funding deficiency of claims incurred prior to that date. As a result, the term "actuarially sound" now applies only to the New Fund for claims incurred on or after July 1, 1990. To be "actuarially sound" state fund management must set New Fund rates at a level sufficient to recover present and future costs of claims incurred during the period the rates are in effect.

State law directs state fund management to:

> "make every effort to adequately predict future costs. When the costs of a factor influencing rates are unclear and difficult to predict, the state fund shall use a prediction calculated to be more than likely to cover those costs rather than less than likely to cover those costs."

We reviewed the assumptions and analysis of the actuary supporting the recommended 15.7 percent premium revenue increase for fiscal year 1991-92. We found the analysis used predictions calculated to be more than likely to cover New Fund costs for the period.

Financing Past Claims Liability

The state fund's actuary valued the liability associated with claims incurred prior to July 1, 1990 at $433,454,000 on June 30, 1991. During fiscal year 1990-91, state fund paid claims and administrative costs of $98,552,379 and $4,440,905, respectively, related to Old Fund accidents. State fund used previously accumulated assets allocated by the legislature and $32 million in loans from assets of the New Fund to pay Old Fund costs.

On July 15, 1991, the Board of Investments issued bonds totalling $142,095,000. The bond proceeds will be used to meet Old Fund claim costs. In addition, the Old Fund repaid loan principal and interest to the New Fund. Bond payments will be

financed with revenues from the .28 percent tax on all payroll covered by workers' compensation insurance.

Section 39-71-2355, MCA, restricts the amount of bonds or New Fund loans that the Board of Investments may provide to the Old Fund. The section states, ". . . the board of investments may not give the state fund loan proceeds or issue workers' compensation bonds unless the aggregate amount of outstanding and proposed loans and bonds can be serviced with no more than 90% of the amount of tax revenue that the department of revenue estimates will be raised by the tax imposed under 39-71-2503 during the remainder of the then current fiscal year and during each succeeding fiscal year through the end of the fiscal year in which the last then outstanding or proposed loan or bond will be repaid or retired." Thus, the Board of Investments may not issue additional bonds or approve loans from the New Fund to the Old Fund unless the tax revenue is sufficient to make the required repayments.

Prior Audit Recommendations

Prior Audit Recommendations

Section 39-71-2361, MCA, established an annual audit requirement for state fund beginning in fiscal year 1990-91. As part of the audit, we reviewed the implementation status of recommendations in the prior state fund audit. Our report of the audit of the Department of Labor and Industry and the State Compensation Mutual Insurance Fund for fiscal years 1988-89 and 1989-90 included seven sections with ten individual recommendations addressed to the state fund. State fund implemented six and partially implemented two recommendations.

One of the partially implemented recommendations concerns the timely deposit of payroll tax checks. The legislature transferred the payroll tax collection function to the Department of Revenue in fiscal year 1991-92, so we make no further recommendation. The issue related to data processing internal security review has been discussed with management.

Since we did not release the prior audit report until March 1991, the state fund did not have sufficient time to implement two recommendations before the start of this audit. We will review the disaster recovery plan for the state fund's minicomputer system and system security officer functions in the next annual state fund audit.

Findings and Recommendations

Administrative Cost Allocation

Section 39-71-2352, MCA, requires the fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund to $3 million.

We determined that the state fund developed procedures to separate administrative and benefit payment costs for the Old Fund and the New Fund. By reviewing these records, we determined the state fund allocation procedures reasonably allocated administrative expenses between the Old and New Funds. We also found the Old Fund administrative costs for fiscal year 1990-91 exceeded $3 million by $1.44 million. The state fund did not limit Old Fund costs to $3 million in fiscal year 1990-91 as required by state law, but only recorded $3 million of these costs in the Old Fund.

State law requires the allocation of costs and restricts the use of certain funding sources. Sections of statute enacted in the May 1990 session:

-- amend the definition of actuarial soundness and self-support to cover the New Fund,

-- limit use of premiums to pay costs of claims incurred on or after July 1, 1990,

-- establish procedures for loans to the Old Fund from the New Fund, and

-- dedicate the payroll tax to payment of pre-July 1, 1990 claims costs.

The purpose of these provisions is to clearly separate the funding sources of the Old and New Funds and relieve current premium payers of costs associated with the unfunded liability of the Old Fund. The state fund incurred Old Fund administrative costs in excess of $3 million, but charged the excess to the New Fund. The law requires both the allocation of costs and the limitation of Old Fund costs to $3 million per year.

State fund officials said it was not possible to comply with provisions relating to administrative cost allocation and limit administrative charges to the Old Fund to $3 million. The dollar limit resulted from a cost estimate prepared by state fund staff prior to approval of budget amendments in 1990 for additional claims management personnel. We noted the section of statute containing the limit had been amended during the 1991 legislative session. The state fund should have sought to amend the administrative cost limit at that time if it was too low.

Recommendation #1

We recommend the state fund:

A. Allocate and limit administrative costs related to pre-July 1, 1990 injuries in compliance with state law; or

B. Seek legislation to amend the limit on administrative costs related to pre-July 1, 1990 injuries.

Payroll Tax Administration

We found an instance where state fund transferred $4,524 in postage and supplies cost associated with administration of the payroll tax to an appropriation funded with premium revenue. State fund management instructed accounting personnel not to charge postage and supplies to the payroll tax appropriation for the remainder of the fiscal year due to inadequate appropriation authority. In the previous section, we noted that state law limits the use of premiums to pay costs of claims incurred on or after July 1, 1990 and dedicates the payroll tax to payment of pre-July 1, 1990 claim costs. Although the payroll tax appropriation and New Fund appropriations were both budgeted in the same program, statutory restrictions prohibited payment of payroll tax administration costs from the New Fund.

Recommendation #2

We recommend state fund comply with statutory restrictions on the use of appropriated funds.

Benefits and Wage Loss

During our audit of the Department of Transportation, we noted that the department allowed employees who are injured and receiving workers' compensation payments for loss of wages to also use their sick or annual leave. Section 39-71-123, MCA, defines as wages . . . "remuneration at the regular hourly rate for overtime work, holidays, vacations, and sickness periods." In addition, section 39-71-701(1), MCA, limits eligibility for temporary total disability benefits to workers who suffer a total loss of wages as a result of an injury.

The state fund provides workers' compensation coverage for the department. Department employees indicated the department has allowed its employees to use sick and annual leave to cover the employee and state share of insurance costs since the 1970's. A state fund official said state fund has reduced workers' compensation benefits for claimants receiving sick pay when made aware of the practice. State Fund paid compensation benefits of $101,436 on 27 accident claims by department employees for accidents occurring during fiscal year 1990-91. Under department procedures, many of these employees received sick leave and vacation leave concurrently with compensation benefits.

According to a state fund official, "vacation pay or annual leave is not treated in the same fashion as sick leave in the Workers' Compensation Act." Section 39-71-736(2), MCA, does specifically state that an injured worker is not considered to have a wage loss if receiving sick leave benefits. The definition of wages, as cited above, includes both sickness and vacation pay. A claimant who receives any sick leave or vacation pay is not entitled to temporary total benefits. By paying temporary total benefits to

these claimants, state fund pays benefits in excess of the limits set by state law.

__Recommendation #3__

We recommend state fund limit payment of temporary total compensation benefits to claimants with total wage loss.

Rate-making Process

The state fund is subject to the Montana Administrative Procedures Act (MAPA). Under MAPA, state fund must adopt administrative rules for its operations. According to section 39-71-2316(6), MCA, state fund premium rates for classifications may only be adopted and changed using a process and procedure established in rules adopted under MAPA. After the rules have been adopted, state fund need not follow MAPA procedures when changing classifications and premium rates.

State fund management adopted rules and used the rules in setting fiscal year 1991-92 premium rates. Several parties challenged the rules and their implementation. The district court decided the rules adopted by state fund were invalid. Since statute vests sole management and control of the state fund with the board of directors, the court ruled that the board, not management, should adopt the rules. The board adopted emergency rules at its December 3, 1991 meeting to replace the ones invalidated by the court. The rate classification issue discussed in the following section and the public participation disclosure section on page 11 deal with state fund rules and procedures.

Rate Classification

State fund assigns premium rates to classifications of payroll defined by type of work performed. These classifications divide the payroll according to the risk of each type of employment. Section 39-71-2316(6), MCA, requires that the state fund use the classifications of employment adopted by the national council on

compensation insurance (NCCI). NCCI files its classifications and rating plans with the state insurance commissioner.

As discussed above, when state fund adopted classifications for fiscal year 1991-92, it adopted a rule referencing the July 1, 1991 policy services underwriting manual. Since the manual could not be reviewed, the court found such an adoption procedure to be improper under section 2-4-302, MCA. To ensure the classifications in use for new premium rates include the latest changes made by NCCI, the state fund could approve new rates which reference the NCCI classifications filed with the insurance commissioner as of a specific date. By referencing filed classifications, any changes in classification would be available for review by the public prior to the implementation date. This way state fund could keep up with classification changes without the necessity of changing its rules each time the board approves a change in premium rates.

Recommendation #4

We recommend state fund adopt payroll classifications by reference to NCCI filings with the insurance commissioner.

Disclosure Issues

Reserve Estimates

Costs associated with workers' compensation claims become payable in years following the accident. Insurers use actuarial methods to value the liabilities associated with accidents which have occurred as of a given date. Actuarial methods project future payments on past claims from trends developed from payments made in previous years adjusted for changes in the legal and economic environment.

State fund hired a consulting actuary to value the liabilities of both the Old and New Fund as of June 30, 1991. The actuary's estimates were based on the paid claims experience of state fund. We also contracted for an independent actuarial valuation of the state fund claims liability. Our contract actuary projected future payments associated with claims using both case reserve and paid claim trends of the state fund. Case reserves are estimates of liability placed on each case by the state fund. Although the estimates varied, both estimates showed a significant increase in incurred claims liability valuation for New Fund and Old Fund claims.

Using actuarial estimates of the state fund's actuary, we noted undiscounted costs projected for Old Fund claims increased by more than $137 million since the previous year's valuation. The New Fund suffered a loss of $10 million during fiscal year 1990-91. The state fund board of directors approved a premium revenue increase, effective January 1, 1992, to recover approximately $5.5 million of the revenue deficiency in the New Fund.

Under section 39-71-2354, MCA, the Old Fund receives revenue from the payroll tax to pay the costs associated with claims incurred on or before June 30, 1990. The Board of Investments also sold bonds secured by payroll tax revenue. The bond proceeds and payroll tax revenue in excess of the amount required to secure the bonds are insufficient to meet costs associated with Old Fund claims. We project the Old Fund will run out of cash in October or November of 1992.

The $220 million limit on bond and New Fund loans set in state law was based on the valuation of the unfunded liability of Old Fund claims at June 30, 1990. The debt service requirements set

in section 39-71-2355, MCA, discussed on page three, and other market factors limited the amount of financing the Board of Investments could obtain for the state fund to less than the $220 million maximum allowed by law.

Public Participation

The district court found the state fund violated statutes concerning public participation in several ways.

-- State fund did not adopt rules for public participation as required by section 2-3-103, MCA. As a result, people who wanted to participate or monitor state fund actions could not determine when public meetings would occur or what actions would be considered. The state fund adopted public participation provisions as part of the emergency rules.

-- State fund did not give notice of rule-making proceedings to all parties who requested such notice. Under section 2-4-302(2), MCA, the state fund shall mail copies of any notice of rate-making proceedings filed with the Secretary of State to parties requesting such notice within three days of the filing.

-- On June 17, 1991, the state fund changed its classifications by adoption of a rule referencing the July 1, 1991 State Compensation Mutual Insurance Fund policy services underwriting manual. Copies of the manual had not been prepared and were not available for review.

In response to the court decision, state fund's board adopted public participation procedures in its emergency rules. Subsequent to the state fund board's action, the plaintiffs appealed the district court decision to the supreme court. Since the board adopted rules as directed by the district court, we make no further recommendation at this time.

Independent Auditor's Report & Agency Financial Statements

Summary of Independent Auditor's Report

Summary of Independent Auditor's Report

The auditor's opinion issued on the financial statements contained in this report is intended to convey to the reader the degree of reliance which can be placed on the amounts presented. The reader may rely on the fairness of the amounts on the statements presented on pages 16 through 26 when analyzing the financial activity of the State Compensation Mutual Insurance Fund.

STATE OF MONTANA

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Operations and EDP Audit

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Performance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the financial statements of the State Compensation Mutual Insurance Fund (state fund), Old and New Funds, as of June 30, 1991, and for the fiscal year then ended as shown on pages 16 through 26. The information contained in these statements is the responsibility of state fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the state fund, as of June 30, 1991, and the results of operations and the cash flows of its Enterprise Funds for the fiscal year then ended in conformity with generally accepted accounting principles.

As discussed in note 11, the Old Fund has insufficient means to meet its incurred claims costs under the current law.

Respectfully submitted,

James Gillett

James Gillett, CPA
Deputy Legislative Auditor

December 3, 1991

STATE COMPENSATION MUTUAL INSURANCE FUND
BALANCE SHEET - ENTERPRISE FUND
JUNE 30, 1991
(in thousands)

	New Fund	Old Fund
ASSETS:		
Cash/Cash Equivalents (note 3)	$ 37,074	$ 673
Receivables (Net) (notes 1 and 2)	61,287	561
Due from Other Funds	574	3,311
Inventories	59	
Long Term Loans/Notes Receivable		4
Investments (note 3)	3,077	
Equipment	1,094	
Accumulated Depreciation	(176)	
Intangible Assets	29	
Other Assets	9,495	
TOTAL ASSETS	$112,513	$ 4,549
LIABILITIES/FUND EQUITY:		
Liabilities:		
Accounts Payable	$ 378	$ 649
Due to Other Funds	690	6
Bonds/Notes Payable (Net) (note 2)		32,000
Property Held in Trust (note 1)	17,115	
Compensated Absences Payable (note 7)	395	
Estimated Insurance Claims (note 4)	91,225	433,454
Total Liabilities	109,803	466,109
Fund Equity:		
Contributed Capital (note 1)	12,019	
Unreserved	(9,309)	(461,560)
Total Fund Equity	2,710	(461,560)
TOTAL LIABILITIES/FUND EQUITY	$112,513	$ 4,549

The notes are an integral part of the financial statements.

STATE COMPENSATION MUTUAL INSURANCE FUND
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS
ENTERPRISE FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 1991
(in thousands)

	New Fund	Old Fund
OPERATING REVENUES:		
Charges for Services	$ 25	
Investment Earnings	3,626	$ 925
Contributions/Premiums	102,454	
Other Operating Revenues	28	43
Net Operating Revenues	106,133	968
OPERATING EXPENSES:		
Personal Services	2,906	2,271
Contractual Services	1,415	1,046
Supplies/Materials	41	37
Benefits	107,896	237,012
Depreciation	121	
Utilities/Rent	76	35
Communications	368	125
Travel	74	26
Repair/Maintenance	61	70
Interest Expense		585
Other Operating Expenses	228	27
Net Operating Expenses (note 5)	113,186	241,234
Operating Income (Loss)	(7,053)	(240,266)
Operating Transfers In (note 6)		12,765
Operating Transfers Out	(2,256)	653
Net Income (Loss)	(9,309)	(226,848)
RETAINED EARNINGS - JULY 1 - As Previously Reported		(222,650)
Prior Period Adjustments		(856)
RETAINED EARNINGS - JULY 1 - As Restated		(223,506)
Residual Equity Transfers		(11,206)
RETAINED EARNINGS - JUNE 30	$ (9,309)	$(461,560)

The notes are an integral part of the financial statements.

STATE COMPENSATION MUTUAL INSURANCE FUND
STATEMENT OF CASH FLOWS - ENTERPRISE FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 1991
(in thousands)

	New Fund	Old Fund
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts for Sales and Services	$ 78,426	$ 24,463
Interest on Loans		
Payments to Suppliers for Goods and Services	(1,996)	(1,335)
Payments to Employees	(2,831)	(2,271)
Cash Payments for Claims	(17,584)	(97,959)
Collection of Notes Receivable	397	374
Other Operating Revenues	53	43
Net Cash Provided by (Used for) Operating Activities	56,465	(76,685)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Proceeds from Issuance of Bonds and Notes (note 2)		32,000
Transfers to Other Funds	(2,577)	
Transfers from Other Funds		13,410
Cash Payments for Loans (note 2)	(32,000)	
Residual Equity Transfers to Other Funds	(5,056)	
Contributed Capital Transfers from Other Funds		5,056
Net Cash Provided by (Used for) Noncapital Financing Activities	(39,633)	50,466
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of Fixed Assets	(1,046)	
Proceeds from Sale of Fixed Assets	782	
Net Cash Used for Capital and Related Financing Activities	(264)	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchasing of Investments	(11,004)	
Proceeds from Sales or Maturities of Investments	27,912	
Interest and Dividends on Investments	3,598	1,024
Net Cash Provided by (Used for) Investing Activities	20,506	1,024
Net Increase (Decrease) in Cash and Cash Equivalents	37,074	(25,195)
Cash and Cash Equivalents, July 1		25,868
Cash and Cash Equivalents, June 30	$ 37,074	$ 673

(Continued to page 19)

STATE COMPENSATION MUTUAL INSURANCE FUND
STATEMENT OF CASH FLOWS - ENTERPRISE FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 1991
(in thousands)

(continued from page 18)

	New Fund	Old Fund
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating Income (Loss)	$ (7,053)	$(240,266)
ADJUSTMENTS TO RECONCILE OPERATING INCOME TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES:		
Depreciation	121	
Interest on Investments	(3,626)	(925)
Interest Expense		585
Change in Assets and Liabilities:		
Decr (Incr) in Accounts Receivable	(28,001)	25,739
Decr (Incr) in Due From Other Funds	9,983	(23)
Decr (Incr) in Inventories	(11)	
Decr (Incr) in Long-Term Loans/Notes Receivable		2
Decr (Incr) in Other Assets	(980)	
Incr (Decr) in Accounts Payable	167	63
Incr (Decr) in Due to Other Funds	(6,403)	6
Incr (Decr) in Deferred Revenue		(856)
Incr (Decr) in Property Held in Trust	997	
Incr (Decr) in Compensated Absences Payable	46	
Incr (Decr) in Estimated Claims	91,225	138,990
Net Cash Provided by (Used for) Operating Activities	$56,465	$ (76,685)

The notes are an integral part of the financial statements.

1. Summary of Significant Accounting Policies

The State Compensation Mutual Insurance Fund (state fund) records activity related to its workers' compensation insurance operations in the Enterprise Fund type. The Enterprise Funds of the state fund are part of, but do not comprise, the entire Enterprise Fund of the state of Montana. These financial statements reflect the financial position and results of operations and cash flows of the state fund, not the state of Montana.

Basis of Accounting

The state fund uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations.

Under the accrual basis, the state fund records revenues in the accounting period earned, if measurable; they record expenses in the period incurred, if measurable.

<u>Fixed assets</u> are valued at actual or estimated historical cost less accumulated depreciation.

<u>Receivables</u> in the New Fund include accrued premiums from the fourth quarter of fiscal year 1990-91 and loans receivable from the Old Fund.

<u>Property Held in Trust</u> consists of required policy holder deposits which secure payment of premiums.

<u>Contributed Capital</u> accounts for assets transferred from the Old Fund to provide the initial capitalization of the New Fund as required by state law.

<u>Fund Entity</u> consists of contributed capital and the net excess or deficit of assets over liabilities.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. State fund insurance operations were classified in the Enterprise Fund type.

The Enterprise Fund type is used to account for operations (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

2. Old Fund and New Fund/Loans

Chapter 4, Special Session May 1990, separated the liability of the state workers' compensation insurance fund based on whether the liability arises from claims for injuries resulting from accidents that occurred before or after July 1, 1990. The legislation establishes separate funding and accounts for claims occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990 referred to as the New Fund. Under provisions of this law, the New Fund loaned the Old Fund $32 million at an interest rate of 7.5 percent. The Old Fund repaid the outstanding loan with proceeds of bonds issued subsequent to balance sheet date as described in note 10.

3. Cash Equivalents and Investments

The state fund invests moneys with the Board of Investments. Investments in the Short-Term Investment Pool (STIP) are considered cash equivalents under the state accounting policy. All investments of the state fund, except securities on loan, are classified in risk category 1, which includes investments that are insured, registered, or uninsured unregistered securities held by the state or its agent in the state's name. The New Fund investment portfolio includes $2 million in securities on loan, classified as risk category 2. Category 2 includes uninsured and unregistered investments for which the securities are held for the Board of Investments or its agent in the state's name. The market value of the New Fund portfolio was $2,644,667 at June 30, 1991.

4. Risk Management-- Public Entity Risk Pools

The Old and New Funds are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Neither fund had acquisitions costs; therefore, no cost is amortized for the period. Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other socio-economic factors. By statute, these funds cannot invest in common stock. Investments are recorded at cost or amortized cost, where applicable. Premiums and discounts are amortized using the straight-line method over the life of the securities. An average life of eight years is used for amortization of mortgage discounts.

New Fund -- Liability coverage to employers for injured employees that are insured under the Worker's Compensation and Occupational Disease Acts of Montana and workers' compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund must insure any employer who desires coverage. At fiscal year-end, approximately 26,500 employers were insured with the New Fund. Anticipated investment income is considered for computing a premium deficiency and employers must pay premiums to the state fund within specified timeframes.

An actuarial study prepared for the New Fund as of June 30, 1991 estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience.

At June 30, 1991, $119,619,000 of unpaid claims and claim adjustment expenses are presented at their net present value of $91,225,000. These claims are discounted at an annual rate of 7 percent. The New Fund uses reinsurance agreements to reduce its exposure to large losses. Reinsurance

permits recovery of a portion of losses from the reinsurers, although it does not discharge the primary liability of the fund as direct insurer. The New Fund did not deduct any claim liabilities related to potential reinsurance recoveries. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis and all liability of the New Fund is terminated.

Old Fund -- The liability and payment of workers' compensation claims for incidents occurring before July 1, 1990, are reported in the Old Fund. There is no premium income; however, funding for claims payments is provided by a 0.28 percent payroll tax on all Montana employers. The 1991 Legislature authorized issuance of revenue bonds to provide necessary operating cash to pay the liabilities of pre-July 1, 1990, accidents. The employer payroll tax will provide funding for bond payments. An actuarial study prepared for the Old Fund as of June 30, 1991, was used to estimate liabilities and the ultimate cost of settling claims that have been reported but not settled and claims that have been incurred but not reported. At June 30, 1991 $433,454,000 of unpaid claims and claim adjustment expenses are presented at face value. Total Old Fund deficit is $461,560,000. This fund generates little interest earnings and does not discount estimated claims liabilities.

5. Administrative Cost Allocation

Section 39-71-2352, MCA, requires the state fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund. The state fund incurred Old Fund administrative costs of $1.44 million in excess of the limit, and charged the excess to the New Fund.

6. Transfers

The state fund transferred $12,765,054 in payroll tax moneys from the Special Revenue Fund payroll tax entity to its Old Fund in fiscal year 1990-91. The payroll tax revenue is recorded in the Special Revenue Fund as required by state law.

7. Compensated Absences

Employees at the state fund accumulate both annual and sick leave. The state fund pays employees for 100 percent of unused annual leave, 25 percent of unused sick leave, and 100 percent of unused compensatory leave credits upon termination. The state fund absorbs expenditures for termination pay in its annual operational costs. At June 30, 1991, the state fund had a leave liability of $395,000.

8. Pension Plan

The state fund and its employees contribute to the Public Employees Retirement System (PERS), a cost sharing, multiple employer, defined benefit pension plan. Established in 1945 and governed by Title 19, Chapter 3, MCA, PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. A reduced retirement benefit may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average salary. Vesting occurs once membership service totals 5 years. State fund was required to contribute 6.417 percent and employees were required to contribute 6.3 percent of annual compensation in fiscal year 1990-91.

As of June 30, 1991, 215 state fund employees were covered by PERS. State fund covered payroll was $4,033,611 and PERS contributions were $258,837 in fiscal year 1990-91.

Actuarial valuations are performed at PERS every two years. The latest valuation was performed as of July 1, 1990. In calculating the pension benefit obligation, the actuary assumed a return on investments of 8 percent, salary inflation increases of 6.5 percent and no change in post retirement benefits.

The "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users

assess the system's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due and make comparisons among employers. The state fund is unable to determine the actuarial present value of credited projected benefits and net assets available for benefits since the information is available only on a total state basis, not agency basis.

The pension benefit obligation at June 30, 1991, for PERS as a whole was $1,173,852,092. The system's net assets available for benefits at cost on June 30, 1991, were $919,474,377 leaving an overall unfunded pension benefit obligation of $254,377,715. The state fund's 1991 contribution represented approximately .1 percent of total June 30,1991, contributions required of all participating entities. The state fund is not responsible for any state system unfunded liability.

Ten-year historical trend information showing the PERS progress in accumulating sufficient assets to pay benefits when due is presented in the system's June 30, 1991, annual financial report. Only the first two years of the required three-year trend information is available.

9. Building

The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. State fund expenses annual payments on the building in its operating budget. As of July 1, 1990, the state fund transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under the agreement, the state fund will pay all costs associated with the building, including utilities, debt service, janitorial services, and maintenance in lieu of paying rent.

10. Subsequent Events

On July 15, 1991, the Board of Investments issued $142,095,000 in Payroll Tax Bonds (Workers' Compensation Program Series 1991). The Series 1991 Bonds are limited obligations of the state of Montana payable solely from and secured by payroll tax revenues raised pursuant to section 39-71-2503, MCA.

11. Old Fund Financing

Under section 39-71-2354, MCA, the Old Fund receives revenue from the payroll tax to pay the costs associated with claims incurred on or before June 30, 1990. The Board of Investments sold bonds secured by payroll tax revenue as described in note 10. The bond proceeds and payroll tax revenue in excess of the amount required to secure the bonds are insufficient to meet costs associated with Old Fund claims. Section 39-71-2355, MCA, restricts the amount of bonds or New Fund loans that may be provided to the Old Fund. Under this law, the Board of Investments may not give the state fund loan proceeds or issue bonds unless the aggregate amount of outstanding and proposed loans and bonds can be serviced with no more than 90 percent of the amount of payroll tax revenue per 39-71-2503, MCA, that the Department of Revenue estimates will be raised during the remainder of the then current fiscal year and during each succeeding fiscal year until the end of the fiscal year in which the last then outstanding or proposed loan or bond will be repaid or retired.

STATE FUND
MONTANA

STATE COMPENSATION MUTUAL INSURANCE FUND
P.O. BOX 4759
HELENA, MONTANA 59604-4759

Stan Stephens, Governor
GENERAL INFORMATION (406) 444-6500

March 5, 1992

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MAR - 6 1992

Mr. Scott A. Seacat
Legislative Auditor
Office of the Legislative Auditor
State Capitol Building
Helena, MT 59620

Dear Mr. Seacat:

Enclosed is our response to the recommendations in your audit of the State Compensation Mutual Insurance Fund.

We appreciate the cooperation of your staff in completing this audit and discussing your findings with us.

State Fund representatives will be happy to answer any further questions about the audit and our response.

Sincerely,

PATRICK J. SWEENEY
President

Underwriting 444-6440
Administration & Finance 444-6490
Claims 444-6500 Legal 444-6480
Executive 444-6518
Medical Payments 444-6460
Policy Services 444-6440

. STATE COMPENSATION MUTUAL INSURANCE FUND

Response to Legislative Audit
for the Fiscal Year Ended June 30, 1991

Recommendation #1

WE RECOMMEND THE STATE FUND:

A. ALLOCATE AND LIMIT ADMINISTRATIVE COSTS RELATED TO PRE-JULY 1, 1990 INJURIES IN COMPLIANCE WITH STATE LAW; OR

B. SEEK LEGISLATION TO AMEND THE LIMIT ON ADMINISTRATIVE COSTS RELATED TO PRE-JULY 1, 1990 INJURIES.

The State Fund's involvement in setting the $3 million limitation on Old Fund administrative costs was very limited. In order to comply with this law, the State Fund would have had to quit paying benefits and managing Old Fund claims once the $3 million limitation was reached and then resume the function once a new fiscal year started. This was not an acceptable option, so activity continued, with the New Fund absorbing the additional administrative costs. The State Fund will seek legislation to allow for actual administrative costs to be charged, as well as to reimburse the New Fund for Old Fund costs incurred in excess of the $3 million limitation.

Recommendation #2

WE RECOMMEND STATE FUND COMPLY WITH STATUTORY RESTRICTIONS ON THE USE OF APPROPRIATED FUNDS.

The State Fund is very conscious of statutory restrictions on the use of appropriated funds. During Fiscal Year 1991, postage costs associated with the payroll tax collection function exceeded the budget. It was necessary to continue sending tax forms and delinquency notices to taxpayers. The State Fund had no choice but to charge these costs to the New Fund. Responsibility for collection of the payroll tax was transferred to the Department of Revenue July 1, 1991.

Recommendation #3

WE RECOMMEND STATE FUND LIMIT PAYMENT OF TEMPORARY TOTAL COMPENSATION BENEFITS TO CLAIMANTS WITH TOTAL WAGE LOSS.

The State Fund concurs with the recommendation that payment of sick leave precludes receipt of compensation benefits, but does not concur with the recommendation that receipt of vacation pay precludes payment of workers' compensation benefits.

The State Fund interprets the workers' compensation statutes to allow for the receipt of annual leave or vacation pay while receiving workers' compensation benefits, but the statutes do not entitle the receipt of sick leave while receiving workers' compensation benefits. This is based on Section 39-71-736(2), MCA, which states an injured worker is not entitled to compensation benefits if the worker is receiving sick leave. We believe this statute to be more specific in regards to the coordination between sick leave and compensation benefits and governs over the more general definition of wages in Section 39-71-123, MCA, which states wages include vacations and sickness periods. The statute defining wages has been traditionally used to determine what is included in calculating the claimant's weekly rate for wage loss benefits and not for determining when there has been a total loss of wages; however, it is unavoidable that the analysis in each case would be very similar.

Because of the express wording in Section 39-71-736, MCA, and a general understanding of how the court would likely interpret this issue, the State Fund will adjust benefits accordingly regarding sick leave received concurrently with workers' compensation benefits, but will not adjust vacation pay at this time. The Department of Transportation has asked for an Attorney General's Opinion asserting that neither sick leave nor vacation pay should be payable to a worker while on workers' compensation benefits. The State Fund will abide by the Attorney General's Opinion when it is received unless or until it is determined differently by the Workers' Compensation Court and/or the Montana Supreme Court.

<u>Recommendation #4</u>

WE RECOMMEND STATE FUND ADOPT PAYROLL CLASSIFICATIONS BY REFERENCE TO NCCI FILINGS WITH THE INSURANCE COMMISSIONER.

The State Fund generally concurs with the recommendation. As stated in the findings, "To ensure the classifications in use for new premium rates include the latest changes made by NCCI, the state fund could approve new rates which reference the NCCI classifications filed with the insurance commissioner as of a specific date."

For ease of reference and in order to conform with the Montana Administrative Procedure Act in Section 2-4-307, MCA, the State Fund will reference the classifications section of the State Compensation Mutual Insurance Fund Policy Services Underwriting Manual, which is periodically updated as of a specific date. We will use July 1, 1991, because that is the last issuance

date of the classifications section and currently in the rules. However, once a specific date is referenced, MAPA in Section 2-4-307(3), MCA, does not allow for updates without a rule change. Your concern in assisting us in keeping up with classification changes without the necessity of continually changing our rules led us to the following solution.

To keep up with changes in classifications filed subsequently with the Insurance Commissioner which are either through NCCI letter filings or the C & R Committee filings, we will have the Board consider adding language to the rule which authorizes the Board to approve changes or new classification codes as they arise.

We are currently in the process of amending the rule regarding Method of Assignment for Classifications of Employments and have scheduled a public hearing for March 18, 1992. We will have an opportunity to make an agency comment before the comment period closes on March 26, 1992, to incorporate the rule amendment as follows:

> (3) The state fund shall assign its insureds to classifications contained in the classifications section of the state compensation mutual insurance fund policy services underwriting manual issued July 1, 1991<u>, or assign new or changed classifications as approved by the board</u>. That section of the manual is hereby incorporated by reference. Copies of the classifications section of the manual may be obtained from the Underwriting Department of the State Fund, 5 South Last Chance Gulch, Helena, Montana 59601.